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IN THE

Supreme Court of the United States

OCTOBER TERM, [redacted] 1969

No. [redacted] 220

THE JEFFERSON STANDARD LIFE INSURANCE COMPANY,
Petitioner,

v.

UNITED STATES OF AMERICA, *Respondent.*

BRIEF AMICI CURIAE OF AMERICAN LIFE CONVENTION AND LIFE INSURANCE ASSOCIATION OF AMERICA IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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INTEREST OF AMICI CURIAE

The American Life Convention and the Life Insurance Association of America are nonprofit voluntary trade associations, both organized in 1906. Their combined membership totals 355 legal reserve life insurance companies located in 46 States, the District of Columbia and three provinces of Canada. These companies account for about 92 percent of the legal reserve life insurance in force in the United States and Canada.

This case involves the construction of the Internal Revenue Code, as amended by the Life Insurance Company Income Tax Act of 1959 (Pub. L. No. 86-69, 73 Stat. 112; Sections 801-820, Internal Revenue Code of 1954, as amended), hereinafter referred to as the 1959 Act. That Act adopts a wholly new approach to the taxation of life insurance companies and, for the first time since 1921, taxes such companies on the basis of an annual determination of income from all sources.

The case presents a number of important issues under the new 1959 Act. The amici address themselves here only to those which have industry-wide application. Of these, one or more affect significantly the Federal income tax computation of almost every life insurance company and their nonresolution has prevented a final determination of the tax liability of many companies for any year since 1957. This is contrary to an orderly and efficient administration of the tax laws which is best served by devoting both Government and private resources to current years and closing out old years as quickly as possible.

In the aggregate, millions of dollars of tax liability are involved in the issues in this case. It can be expected, therefore, that the present differences between the Government and the life insurance company taxpayers on these many issues will remain unresolved, and, consequently, the tax liabilities unsettled, until this Court decides the substantive questions involved.

The desirablity of final resolution of these issues by this Court, and even a reference to this case as a possible appropriate vehicle for their resolution, has already been acknowledged by the Government in its brief opposing a Petition for a Writ of Certiorari in

a prior case (*Franklin Life Insurance Company* v. *United States*, 399 F. 2d 757 (7th Cir. 1968), *cert. denied* 89 S. Ct. 989 (1969)). That case involved some of the same issues as this case. This case, however, involves a considerably larger number of important issues of first impression under the new 1959 Act. The amici, accordingly, file this brief in support of the Petition for a Writ of Certiorari.

The consent of the parties to the filing of this brief amici curiae has been filed with the Clerk of the Court.

OPINIONS BELOW, JURISDICTION AND THE STATUTES INVOLVED

The amici respectfully refer the Court to the Petition for the statement of the Opinions Below, Jurisdiction, and Statutes Involved.

QUESTIONS PRESENTED

1. Whether the loading element included in premiums which are deferred and uncollected at the end of a tax year must be reported by a life insurance company for the purpose of determining its gain or loss from operations for that year?

2. Whether the loading element included in premiums which are deferred and uncollected at the end of a tax year must be included as an asset for purposes of determining the company's taxable investment income for that year?

3. Whether unearned interest on policy loans as of the end of a tax year must be reported as income for that year merely because it was received or added to the loan principal during the year?

4. Whether amounts advanced to agents against future commissions are assets which must be included

in determining the company's taxable investment income?

5. Whether reserves set up by a life insurance company for its own retirement plan qualify as life insurance reserves as defined in section 801(b) of the Internal Revenue Code?

6. Whether an allocable portion of a life insurance company's charitable contributions may be deducted in determining its taxable investment income?

STATEMENT

The amici respectfully refer the Court to the Petition for a full statement of the facts, and here indicate only sufficient detail for an understanding of the basic questions involved.

1. *Premiums Deferred and Uncollected (Questions 1 and 2)*—Under the 1959 Act, life insurance companies are taxed on a calendar year basis. On the other hand, life insurance premiums and the related reserves are calculated on a policy-year basis beginning on each anniversary of the policy. In practically all cases, the tax year and the policy year do not coincide. Moreover, premiums are charged to policy owners in many cases on a quarterly or more frequent basis. At the end of each taxable year, a life insurance company will, therefore, have in force insurance policies with fractional premiums which are not "due" until the subsequent year, as well as policies with premiums "due" and unpaid but within the grace period. These two classes of premiums constitute "premiums deferred and uncollected." All such premiums are payable at the election of policyholders and the insurance company has no right to have them paid. If the policyholders do not pay these premiums in accordance with

the provisions of the policies, the policies are cancelled after the grace period and appropriate adjustments are made to the reserves.

Gross premiums are the agreed prices stated in the life insurance contract. That part of the premium intended to meet the cost of insurance, both current and future, is called the net premium (or net valuation premium). In addition, there is a loading on the premium, which is a sum added to the net premium to cover sales commissions, administration, management and operating expenses, as well as contingencies, and in some cases profits. The gross premium is a combination of the net premium and the loading.

Life insurance companies are required by state law to maintain reserves for their life insurance policies. These reserves are computed on the assumption that all premiums—including deferred and uncollected premiums—have been collected in advance at the beginning of each policy year. Under the accounting methods prescribed by the National Association of Insurance Commissioners and required by the states, the *net* portion of deferred and uncollected premiums is reflected as an asset of the company to offset the reserve liability which is also set up on a *net* premium basis.

Within the context of these special accounting procedures, two income tax questions arise. First, while it is granted by all parties that the net portion of deferred and uncollected premiums should be included as premium income to balance the deduction allowable for the addition of this amount to reserves, the Government also contends that the loading element in these deferred and uncollected premiums must be treated as an item of premium income. The Government takes

a similar position requiring the loading element in these premiums to be treated as an asset of the company for purposes of computing its taxable investment income.*

On both these issues, the District Court upheld the Government and the Court of Appeals affirmed the District Court.

2. *Unearned Interest*—Life insurance companies, in making loans based on the cash value of policies, may receive each year's interest in advance (*i.e.*, at the beginning of the policy year) or, if not paid in cash, the company may add the interest for the year to the principal of the loan as of the beginning of the policy year. If a policyholder repays a loan before the end of the policy year, the life insurance company credits him with a pro rata share of the interest representing the unearned amount. When the end of the life insurance company's tax year falls in the middle of a policy year in such a situation, the issue arises as to whether the portion of the interest attributable to a period after the close of the tax year must, nevertheless, be included as income for that tax year even though it has not as yet been earned and will have to be repaid if the loan is paid off before the end of the policy year. The Government contends that it must be so included.

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*It is important in applying the 1959 Act formula that items not be included in assets unless they are in fact assets within the meaning of section 805(b)(4). The policyholders' share of investment income, which is excluded from tax, is determined by multiplying the company's earnings rate against the adjusted life insurance reserves. The earnings rate is based on the ratio of investment income to assets. Thus, if the assets figure is improperly increased, the earnings rate will be lower, the exclusion for the policyholders' share will be decreased, and the company's taxable investment income will be increased.

The District Court upheld the Government and the Court of Appeals affirmed the District Court.

3. *Agents' Debit Balances*—Agents' debit balances represent a life insurance company's advances to its salesmen for living and operating expenses. They are chargeable against future commissions. The issue is whether these balances, which are not interest bearing, must be included as an "asset" for purposes of determining the company's taxable investment income or whether they are excluded therefrom as assets used in carrying on an insurance trade or business (section 805(b)(4) of the Internal Revenue Code). Since these balances earn no interest, their inclusion in "assets" will, under the framework of the 1959 Act, lower the overall earnings rate of the petitioner and, consequently, lower the deduction it may claim for additions to its reserves out of investment income.*

The Court of Appeals affirmed the District Court's decision that these debit balances must be included as "assets" in applying the investment income formula.

4. *Branch Office Managers Retirement Plan*—Petitioner established a supplemental retirement plan for its Branch Office managers and maintained reserves for this plan as required by State law. Benefits under the plan were forfeitable under certain situations. Moreover, the plan did not meet the special tax qualification provisions of section 401 of the Internal Revenue Code —which provisions do *not* require complete nonforfeitability. The issue involved is whether the reserves underlying this retirement plan qualify as life insurance reserves, as defined in section 801(b) of the In-

* See footnote on page 6 for a more complete explanation of the importance of not including an item in "assets" unless it is in fact an asset within the meaning of section 805(b)(4).

ternal Revenue Code, so as to allow the taxpayer a deduction for additions it makes thereto.

The Court of Appeals (in affirming the District Court) held that the reserves did *not* qualify as life insurance reserves, despite the fact that they clearly met all the requirements set forth in section 801(b), including the one which provides that they be required by law. The Court came to this conclusion even though it acknowledged that, had the plan met the section 401 tests, the reserves would have qualified as "pension plan reserves"—eligible for a special deduction for additions thereto under section 805(a)(2). Under the definition of "pension plan reserves" contained in section 805(d), a reserve must first qualify as a life insurance reserve.

5. *Charitable Contributions*—The issue is whether a life insurance company may deduct an allocable part of its charitable contributions against its investment income in computing the investment income portion of its taxable income (Phase I) or whether such contributions may only be deducted in computing the underwriting portion of its taxable income (Phase II). Because of the structure of the 1959 Act in not currently taxing underwriting gain as heavily as investment income, or the possibility that a company may not have any underwriting gain in a particular year, a company's tax liability will differ depending on whether a portion of its charitable contributions may be offset against investment income. The Government contends that charitable contributions are deductible only against underwriting income.

The District Court ruled against the Government; however, the Court of Appeals reversed the District Court.

REASONS WHY THE WRIT SHOULD BE GRANTED

As already indicated, this case involves a large number of important issues under the 1959 Act which have never been ruled upon by this Court. Many life insurance companies are confronted with these issues. As a result, these many companies have been unable to close out the audits for any tax year since 1957—*i.e.*, the effective date of the 1959 Act. Such a situation is clearly disruptive to the orderly application of the tax laws. Moreover, the longer final resolution is delayed, the more years there will be in dispute. If any substantial progress is to be made in correcting this situation, the issues in this case must be finally resolved by this Court.

There is no reason to believe that these issues will be settled short of Supreme Court review. The aggregate tax liabilities are so large that the parties may be expected to resort to litigation rather than reaching agreement. This is evidenced by the results of the questionnaire circulated by Petitioner and referred to in its Petition. Moreover, on the deferred and uncollected premiums issues, there is disagreement among the lower Courts. While the Court of Appeals in the *Franklin Life* case ruled for the Government on those two issues, as did the Court of Appeals here, the Tax Court has held that the loading on deferred and uncollected premiums should not be included in assets (*Western National Life Insurance Company* v. *Commissioner*, 51 T.C. No. 81 (February 24, 1969)).

The Government itself has admitted the desirability of settling the income tax liabilities of life insurance companies under the new 1959 Act by having the Supreme Court resolve the major issues outstanding. While the Government successfully opposed certiorari

in the *Franklin Life* case, its brief there indicated that review would be appropriate in a case such as the one at bar where a large number of important issues under the new Act are involved. Speaking of the deferred and uncollected premiums issues, the Government there said:

> "Although we believe that petitioner has grossly exaggerated the revenue consequences of the decision below, we agree that it is an industry-wide issue and has significant monetary importance. We would therefore not oppose certiorari even in the absence of a conflict if it appeared that present review would facilitate the final settlement of the income tax liabilities of this and other life insurance companies. But review would not dispose of those cases, since they involve other important questions of statutory construction—most of them industry-wide issues involving substantial amounts—as well as the deferred and uncollected premiums issue. In addition, a grant of certiorari here well might freeze those cases in their present status and further postpone the date on which audits of the life insurance companies may be closed." (See pages 17-18 of Brief for the United States in Opposition to Certiorari in the *Franklin Life Case.*)

A footnote to the above-quoted statement specifically refers to the *Jefferson Standard* case as one involving a significant number of issues. In fact, the *Jefferson Standard* case involves seven industry issues—the six referred to in this brief and one decided in favor of the Petitioner by the Court of Appeals—while the *Franklin* case involved only three of these issues.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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